

Banking Economics

Lecture 3

Banking Intermediation

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(Slides adapted from Fátima Sol Murta and João Ricardo C.)



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Outline, Goals, and Main Bibliography

► Outline:

1 Banking intermediation

1.1. Definition and specificity of banking intermediation

1.2. The evolution of banking systems and the European and Portuguese banking sectors

1.3. The banking sector and the SDGs

► Goals:

Characterize the activity of banking intermediation, understand its importance and its benefits for economic agents;

Describe and relate the trends that characterize the banking sector today, particularly in Portugal and Europe.

► Main Bibliography:

Casu, B., Girardone, C., & Molyneux, P. (2006). *Introduction to Banking*. FT Prentice Hall.
(Chapters 1 and 2)

1.1. Definition and specificity of banking intermediation

- ▶ A bank is a financial intermediary whose core activity consists in collecting deposits from savers and providing loans to agents in need of finance.
- ▶ Thus, banks' major assets are loans, and major liabilities are deposits.

BANKS	
Assets	Liabilities
Loans	Deposits

1.1. Definition and specificity of banking intermediation

- ▶ To fully understand the **advantages** of the **intermediation process**, it is necessary to analyze what banks **do** and **how they do it**.
- ▶ We have seen that the **primary function** of banks is to **collect funds (deposits)** from agents with **surplus** and **lend funds (loans)** to agents with a **deficit**.
- ▶ **Deposits** are typically **small** in size, **low-risk**, and **highly liquid**, while **loans** tend to be **larger**, **riskier**, and **illiquid**.
- ▶ Banks **bridge the gap** between the **needs of lenders** and **borrowers** by performing a **transformation function**:
 - a) **Size transformation**;
 - b) **Maturity transformation**;
 - c) **Risk transformation**.

a) Size transformation

“Generally, **savers/depositors** are willing to lend **smaller** amounts of money than the amounts **required** by **borrowers**.

For example, think about the difference between your savings account and the money you would need to buy a house!

Banks collect funds from savers in the form of **small-size deposits** and **repackage** them into **larger size loans**.

Banks perform this **size transformation** function exploiting **economies of scale** associated with the **lending/borrowing** function, because they have access to a **larger number of depositors** than **any individual borrower**” (Casu et al., 2006, p. 7).

b) Maturity transformation

“Banks transform funds lent for a short period of time into **medium- and long-term loans**.

For example, they convert **demand deposits** (i.e., funds deposited that can be withdrawn on demand) into **25-year residential mortgages**.

Banks' **liabilities** (i.e., the funds collected from **savers**) are mainly repayable **on demand** or at relatively **short notice**.

On the other hand, banks' **assets** (funds lent to **borrowers**) are normally repayable in the **medium- to long-term**.

Banks are said to be ‘**borrowing short and lending long**’ and in this process they are said to ‘**mismatch**’ their **assets and liabilities**.

This mismatch can create problems in terms of **liquidity risk**, which is the risk of **not having enough liquid funds** to meet one's **liabilities**” (Casu et al., 2006, p. 8).

c) Risk transformation

“Individual borrowers carry a risk of default (known as credit risk), which is the risk that they might not be able to repay the amount of money they borrowed.

Savers, meanwhile, wish to minimise risk and prefer their money to be safe.

Banks are able to minimise the risk of individual loans by diversifying their investments, pooling risks, screening and monitoring borrowers and holding capital and reserves as a buffer for unexpected losses” (Casu et al., 2006, p. 8).

Risks arising from the transformation function

Some risks that banks incur stem from the transformation function they perform. In particular:

- ❑ We saw that the **liability** structure of banks' balance sheets tends to reflect a **shorter maturity** structure than that of their **asset** portfolio (**maturity transformation**);
- ❑ This **maturity mismatch** gives rise to **liquidity risk**, which refers to the possibility that the bank **may run out of liquid funds** to **meet its short-term obligations**.
- Implicit in banks' **risk transformation** function is the idea that banks **bear the credit risk of borrowers**;
- The **deposits** through which banks collect **savings** are almost **risk-free**, but they **lend** funds to **borrowers** who, due to internal or external factors, **might not be able to fulfill their loan repayments**;
- In other words, the fact that banks use almost **risk-free liabilities** to fund **risky assets** means that they operate with **exposure to credit/default risk**.

How to manage and mitigate these risks?

- ▶ As we will study later, and as we have already briefly discussed, **banks are well-positioned to manage and mitigate these risks.**
- **Banks continuously manage their liquidity risk by planning their liquidity levels in advance.** Additionally, certain mechanisms help banks mitigate liquidity risk, including the interbank market, deposit insurance, and central bank refinancing.
- Additionally, **banks also implement specific strategies and make deliberate decisions to reduce the credit risk underlying their loan portfolios, such as:**
 - Conducting a **thorough analysis** of borrowers;
 - **Monitoring** financed projects;
 - Requiring **guarantees** to secure loans;
 - **Diversifying** loans (diversification reduces **firm-specific** or **sector-specific risk**);
 - Ensuring **compliance with regulatory requirements**, such as **minimum capital ratios** (capital/equity acts as a **buffer** against losses when credit risk materializes).

Main takeaway

- ▶ Savers generally prefer to apply their small-sized savings in short-term, liquid, and safe products, unlike borrowers, who typically seek to borrow large sums of funds from long-term sources and whose activities involve various risks.
- ▶ To bridge these opposing needs of savers and borrowers, banks act as intermediaries, offering products to both sides tailored to their desired features.
- ▶ This process of reconciling mismatched needs is known as the asset transformation function of banks, and it operates on different dimensions: size, maturity, and risk.
- ▶ By enabling savers and borrowers to access financial products and services aligned with their needs, banks facilitate the channeling of funds from savers to borrowers, contributing to a more efficient allocation of capital and, ultimately, to economic growth.

1.1. Definition and specificity of banking intermediation

► Two important **questions** remain to be addressed:

- 1) What **distinguishes** banks from other financial intermediaries (or financial institutions) ?
- 2) What **additional activities** do banks engage in beyond accepting deposits and issuing loans ?

1) What distinguishes banks from other financial intermediaries (or financial institutions) ?

- Unlike pension funds, insurance companies, and other financial intermediaries, **banks are deposit-taking or monetary institutions**, as they can accept deposits, and these deposits function as money.

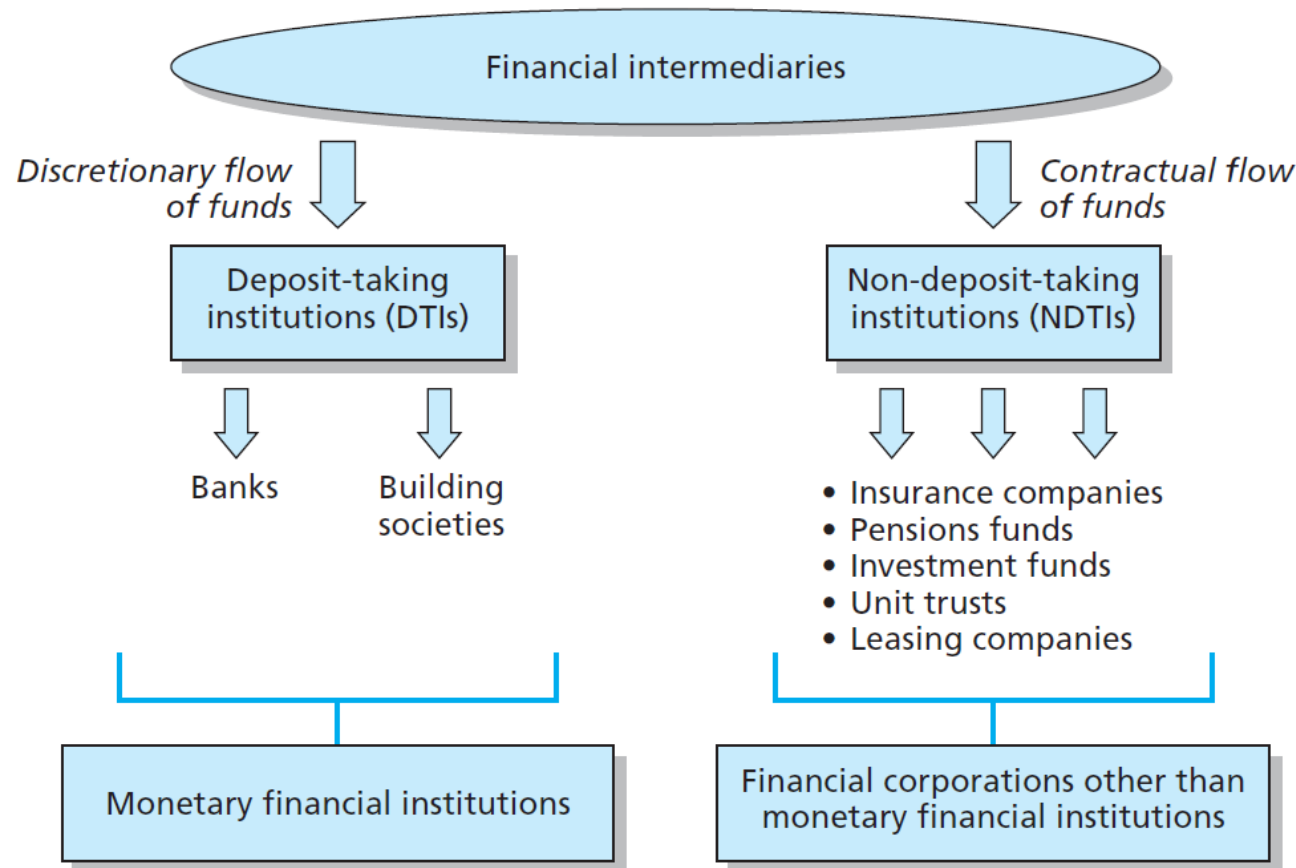


Figure 1. Classification of financial intermediaries in the UK. Source: Casu et al. (2006)

2) What additional activities do banks engage in beyond accepting deposits and issuing loans?

- ▶ The modern answer: many activities. The traditional banking model recognizes the **acceptance of deposits** and the **issuance of loans** as the **main activities** of banking institutions. However, modern banking is grounded in the **universal banking model**: today, banks are **permitted to perform** an **increasingly broad range of financial services**.
- ▶ Let's take a look at the case of the UK. According to the UK's Financial Services and Markets Act 2000, which defines the **range of activities** that **banks can engage in**, banks can:
 - ❖ Accept **deposits**;
 - ❖ Issue **loans**;
 - ❖ Issue **e-money** (or digital money), i.e., electronic money used on the internet;
 - ❖ Implement or carry out **contracts of insurance**;
 - ❖ **Deal in investments**;
 - ❖ **Advise on investments**;
 - ❖ **Safeguard and administer investments**;
 - ❖ **Advise on regulated mortgage contracts**;
 - ❖ **Establish and manage collective investment schemes** (for example, investment funds and mutual funds);
 - ❖ **Establish and manage pension schemes**.